

ISSUE

Under the circumstances described below, is the donation to a private foundation by a disqualified person of a life insurance policy subject to a policy loan an act of self-dealing within the meaning of section 4941(d) (1) (A) of the Internal Revenue Code?

FACTS

The organization is exempt from federal income tax under section 501(c) (3) of the Code, and is a private foundation under section 509(a).

A disqualified person, as defined in section 4946(a) of the Code, donated a life insurance policy to the foundation. The policy, which has a face value of \$100x, is subject to an outstanding loan of \$46x that was previously made to the disqualified person by the insurer within a 10-year period ending on the date of donation, at which time the cash surrender value of the policy was \$50x. Under the terms of the policy, failure to repay the principal or interest on the policy loan reduces the proceeds that are payable to the beneficiary upon voluntary surrender of the policy or upon the death of the insured.

LAW

Section 4941 of the Code imposes a tax on each act of self-dealing between a disqualified person and a private foundation.

Section 4941(d) (1) (A) of the Code provides that the term 'self-dealing' means any direct or indirect sale or exchange, or leasing, of property between a private foundation and a disqualified person.

For purposes of section 4941(d) (1) of the Code, section 4941(d) (2) (A) provides that a transfer of real or personal property by a disqualified person to a private foundation shall be treated as a sale or exchange if the property is subject to a mortgage or similar lien which the foundation assumes or if it is subject to a mortgage or similar lien which a disqualified person placed upon the property within the 10-year period ending on the date of transfer.

Section 53.4941(d)-2(a) (2) of the Foundation Excise Tax Regulations provides that the transfer of real or personal property by a disqualified person to a private foundation shall be treated as a sale or exchange if the foundation takes the property subject to a mortgage or similar lien which a disqualified person placed on the property within the 10-year period ending on the date of transfer. The regulation further provides that the term 'similar lien' shall include, but is not

limited to, deeds of trust and vendors' liens, but shall not include any other lien if such lien is insignificant in relation to the fair market value of the property transferred.

ANALYSIS

A loan on a life insurance policy is sometimes characterized as an advance of the proceeds of the policy. The insurer will not demand repayment of the loan, but a failure to repay the loan will reduce the cash surrender value of the policy and the amount payable on the death of the insured. Similarly, the insurer will not demand payment of interest on the loan as it accrues, but a failure to pay the interest will further reduce the cash surrender value of the policy and the amount payable on the death of the insured. Thus, the loan constitutes a charge against the policy. Compare J. Simpson Dean, 35 T.C. 1083 (1961), nonacq. 1973-2 C.B. 4 (nonacquiescence on another issue).

The fact that the insurer will not demand repayment of the loan or payment of interest as it accrues does not mean that the loan is not a 'mortgage or other lien' within the meaning of section 53.4941(d)-2(a)(2) of the regulations. The transfer of the policy in the instant case relieves the donor of the obligation to either repay the loan, pay interest on the loan as it accrues, or suffer continued diminution in the value of the policy. Thus, the effect of the transfer is essentially the same as the transfer of property subject to a mortgage or similar lien. In addition, the amount of the loan is not insignificant in relation to the value of the policy.

HOLDING

The donation of the life insurance policy described above, which is subject to an outstanding policy loan, is a transfer of real or personal property by a disqualified person to a private foundation and is an act of self-dealing under section 4941(d)(1)(A) of the Code.

See Rev. Rul. 80-133, this page, this Bulletin, for the application of section 4944 of the Code to a similar transaction where the donor is not a disqualified person.